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No. 73-325

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In the Supreme Court of the United States

OCTOBER TERM, 1973

WAYNE E. BROWN AND MARY RUTH BROWN,
PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

ROBERT H. BORK,
Solicitor General,
Department of Justice,
Washington, D.C. 20530.

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In 1950, petitioners received a tax-free dividend of preferred stock in Big Bear Stores Company ("Big Bear") on the basis of one share of preferred stock for each share of common stock held (Pet. App. 30). At that time, petitioners held 932 of the 3,500 shares of common stock outstanding and received 932 shares of the 3,500 shares of preferred stock issued as a stock dividend (Pet. App. 30). Thereafter, Big Bear's common stock was reclassified into nonvoting Class A and voting Class B stock (Pet. App. 30-31). In 1957, petitioners acquired 99.3 per cent control of the Class B voting stock (Pet. App. 31). During that year, Big Bear also created a new issue of prior preferred stock which replaced the 1950 issue of preferred stock on a share for share basis (Pet. App. 31).

The preferred stock was issued with a sinking fund provision that required an annual deposit from net earnings adequate to redeem 100 shares each year. Although the sinking fund was never formally established, the corporation complied with its requirements by redeeming shares directly from stockholders at the rate of 100 shares per year until the issue was retired (Pet. App. 32). In 1964, as part of the redemption plan, Big Bear redeemed 200 shares of petitioners' preferred stock for $21,000 (Pet. App. 31). At the time of the redemption the percentage of all shares held by petitioners in Big Bear was as follows: Class A stock—11.7 percent; Class B stock—99.3 percent; preferred stock 34.01 percent (Pet. App. 31).

The district court upheld the Commissioner's determination that the redemption of petitioners' preferred stock was "essentially equivalent to a dividend" within the meaning of Section 302(b)(1) of the Internal Revenue Code of 1954 so that the $21,000 they received was taxable as ordinary income and not as capital gain (Pet. App. 40).[1] In a brief order, the court of appeals affirmed (Pet. App. 41) and subsequently denied petitioners' petition for rehearing and suggestion of rehearing *en banc* (Pet. App. 42).

1. Contrary to petitioners' contention (Pet. 20-23), the decision below is not in conflict with *United States* v. *Davis*, 397 U.S. 301, but rather is in accord with that decision.

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[1] The italicized word "not" appearing in the Conclusions of Law as printed in the Appendix to the Petition (Pet. App. 40) was erroneously inserted before the words "substantially equivalent to a dividend" in the Conclusion of Law as originally filed by the district court. This error was subsequently corrected in the published opinion. See 345 F. Supp. 241.

Distributions to shareholders out of a corporation's earnings and profits are generally treated as taxable dividends under Sections 301 and 316 of the Internal Revenue Code of 1954. Similarly, distributions made by a corporation in redemption of its stock are treated as dividends unless the redemption qualifies under one of the four exceptions in Section 302(b).[2] The exception here at issue is Section 302(b)(1), which provides that a corporation's redemption of stock shall be treated as a distribution in part or full payment in exchange for the stock if the redemption is "not essentially equivalent to a dividend." If the redemption so qualifies, the difference between the amount received by the shareholder and his cost basis in the stock will be taxable as capital gain.

In testing for dividend equivalency under this provision, this Court, in *United States* v. *Davis, supra,* 397 U.S. at 310-311, stated that Congress intended Section 302(b)(1) to apply to only those redemptions which could be characterized as a sale of the stock by the shareholder to the corporation. If the surrender of stock by a shareholder in a redemption is a meaningless act carrying with it no substantial change in ownership rights, such a transaction could hardly be deemed to be a sale. Accordingly, the Court in *Davis* approved the strict net effect test which denies capital gains treatment under Section 302(b)(1) unless the redemption results in a meaningful reduction of the shareholder's proportionate ownership interest in the corporation.

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[2] That the law of Ohio, cited by petitioners (Pet. 27-28), might prohibit the use of a redemption as a guise for a dividend distribution does not prevent the taxation of the distribution in question as a dividend in accordance with the requirements of the Internal Revenue Code.

The redemption here is precisely the type of transaction that Section 302 and its predecessors[3] were designed to subject to dividend treatment. Indeed, the original antecedent of Section 302, adopted in 1921 after this Court's decision in *Eisner* v. *Macomber*, 252 U.S. 189, holding that pro rata stock dividends were not taxable, was specifically directed to imposing dividend taxation upon the redemption of stock that had been distributed as a tax-free stock dividend. See *United States* v. *Davis, supra*, 397 U.S. at 308. Viewing the overall economic effect of the stock dividend here and the subsequent redemptions of Big Bear preferred stock over the years during which its redemption plan was in effect, there was no meaningful change in the proportionate ownership and control of the corporation by reason of the redemption.

Indeed, during the relevant period, 1950-1967, petitioners' proportionate interest in the preferred stock actually increased from 26.63 percent to 35.47 percent.[4] Where a shareholder's proportionate interest

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[3]Section 201(d) of the Revenue Act of 1921, 42 Stat. 228; Section 201(g) of the Revenue Act of 1926, 44 Stat. 11; Section 115(g) of the Revenue Act of 1928, 45 Stat. 822. Section 115(g) was carried over in the 1939 Code.

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[4] The percentage of preferred stock owned by petitioners at various times was as follows (Pet. App. 38):

1. June 20, 1950 (when the redemption plan for the 1950 issue was instituted)—26.63 percent.

2. January 16, 1957 (when the remaining unredeemed 3,090 shares of the 1950 issue preferred were retired and the prior preferred stock issued)—30.16 percent.

3. February 29, 1964 (when petitioners' 200 shares of 1950 issue preferred were redeemed)—29.16 percent.

is increased as a result of the redemption plan, the outcome is "most unlike a sale" and capital gain treatment is inappropriate. *Levin* v. *Commissioner,* 385 F. 2d 521, 527-528 (C.A. 2); *Blount* v. *Commissioner,* 425 F. 2d 921, 925 (C.A. 2). Moreover, the preferred stock redemption had no effect on any of petitioners' common stockholdings. Their relative voting rights (99.3 percent) with respect to their common stockholdings remained the same after the redemption. Thus, taking into account the fact that there was no change in shareholder relationships, much less a meaningful one, both courts below correctly held, under the rule announced in *Davis,* that the $21,000 payment was taxable as a dividend.

Contrary to petitioners' contention (Pet. 24-26), the courts below properly looked to the overall economic effect of all the redemptions by Big Bear over the period 1950 to 1967. See, *e.g., Blount* v. *Commissioner, supra; In re Lukens' Estate,* 246 F. 2d 403 (C.A. 3); *Stein* v. *United States,* 62 F. Supp. 568 (Ct. Cl.). Cf. Section 302(b)(2)(D).[5] However, even if the redemption here is considered only during the taxable year at issue, 1964, the *Davis* standard for nondividend equivalency was not met. The one percent decrease in petitioners' proportionate interest in the preferred stock between January 16, 1957 (30.16 percent) and the date of the redemption (29.16 percent) was hardly a meaningful change.

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4. February 25, 1967 (the last date supplied to the district court as of which 2,024 shares of preferred stock were not yet redeemed)—35.47 percent.

[5] Nothing in *Commissioner* v. *Gordon,* 391 U.S. 83, relied upon by petitioners (Pet. 25), would prevent viewing the net effect of Big Bear's redemption plan as a whole.

2. Contrary to petitioners' contentions (Pet. 14, 16-20, 22-23), the decision below is not in conflict with that of any other circuit. Although both the Second Circuit in *Himmel* v. *Commissioner,* 338 F. 2d 815, and in *Northrup* v. *United States,* 240 F. 2d 304, and the Fourth Circuit in *Commissioner* v. *Estate of Antrim,* 395 F. 2d 430, have employed a different hypothetical dividend test for determining dividend equivalency, the district court correctly observed (Pet. App. 39-40) that these decisions can no longer be viewed as viable in the light of this Court's adoption of the strict net effect test in *Davis.*[6]

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

ROBERT H. BORK,
Solicitor General.

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[6] Petitioners' reliance (Pet. 19) upon *Stanley F. Grabowski Trust* v. *Commissioner,* 58 T.C. 650, is also unfounded. Unlike this case, the Tax Court there, in upholding the Commissioner, observed that the taxpayer did not even meet the requirements of the hypothetical dividend test.

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